Docket No. 13608

In the

United States Court of Appeals

For the Ninth Circuit

THE JOHN DANZ CHARITABLE TRUST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent,*

ON PETITION FOR REVIEW OF DECISION OF THE TAX COURT OF THE UNITED STATES

REPLY BRIEF FOR THE PETITIONER

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I.

PETITIONER IS EXEMPT UNDER I.R.C. §101(6)

While admitting that the purposes for which Petitioner was organized and operated were charitable (Br. 27-28), and that no part of its fund or income can inure to a private individual (Br. 18, 28), nevertheless Respondent argues that exemption under I.R.C. §101(6) is not available, based on a number of intermingled contentions. To aid in understanding these contentions, it is necessary to separate and analyze them. They include argument that (1) an organization must be engaged in "functional charitable activities" of its own to secure exemption; (2) if an organization has no "functional charitable activities" of its own, it may secure exemption only by "relationship" to some or-

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I.

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ganization that does carry on such activities; (3) there is no generally accepted destination test for exemption; and (4) receipt of business income destroys exemption, even if there is no primary purpose of operating business enterprise. We deal with each of these arguments separately.

As a preliminary, we wish to refer to Respondent's practice, throughout his brief, of stating that funds were to be paid only to exempt organizations selected by John Danz during his lifetime and by his will (for example, Resp. Br., pp. 2-3, 16, 47, 50), omitting the important provisions that if he fails to specify beneficiaries for the entire corpus and income, then the entire balance will go to exempt beneficiaries selected by designated grandchildren or by the trustees. Where the entire fund has been given irrevocably for charitable purposes, the exemption is not affected by the fact that the donor or members of his family have the power to select the particular charitable beneficiaries. *Harrison v. Barker Annuity Fund,* 90 F.(2d) 286 (C.C.A. 7th); *Schoellkopf v. U. S.,* 124 F.(2d) 982 (C.A. 2d); *Wm. H. Donner,* 40 B.T.A. 80; *Estate of Louise V. Simpson,* 2 T.C. 963; *Eppa Hunton IV,* 1 T.C. 821 (Acq. 1943 C.B. 12); *Cummins-Collins Foundation,* 15 T.C. 613.

A. "Functional Charitable Activities" Not Necessary to Exemption

The contention that an organization must itself be engaged in "functional charitable activities" to be exempt is entirely new on the part of the Commissioner. It was not argued below at any stage, it did not enter into the decision of the Tax Court in this case, and as

far as Petitioner can determine, it was not argued in any of the recent cases involving application of I.R.C. §101(6).

What Respondent means by the phrase "functional charitable activities" is difficult to determine. The phrase is not defined in his brief, it is not to be found in the statute and as far as we know has never been used, and certainly not defined, by any court. Apparently what Respondent has in mind is the actual conduct of some particular exempt activity, like the conduct of classrooms in a school or the conduct of church services, as distinguished from the supplying of money or property to assist another organization in the conduct of these activities.

If this meaning of the phrase "functional charitable activities" is what Respondent intends, then it should be pointed out that Respondent's argument implies that every charitable foundation, trust and corporation in this country that is engaged solely in supplying money to other charitable institutions has no exemption. It would make no difference whether the income of the foundation came from conduct of a business or entirely from Government bonds, the organization would be taxable unless it took over conduct of the classrooms from the colleges it was supporting, or conduct of the services from the churches it was supporting.

One would expect that such a drastic proposal would be found in a general statement by the Treasury Department or Congress rather than simply in a brief filed in a single case in court. The fact is that there have been statements on this subject, by both the Treasury Department and Congress, and these statements are con-

trary to Respondent's contention. Also, the court decisions that have discussed this subject are contrary to such contention.

In 1924, the Income Tax Unit ruled in I.T. 1945 (III-1 C.B. 273) that a corporation which did not actually engage in charitable undertakings itself but distributed its income to exempt institutions was exempt under §231(6) of the 1918 and 1921 Revenue Acts (substantially identical with I.R.C. §101(6) here involved). This ruling has never been revoked and still stands as the announced policy of the Bureau of Internal Revenue on this subject.

This argument of Respondent, including the argument (Br. 28) that I.R.C. §101(14) is the only section offering exemption to an organization created to supply funds and property to charitable organizations, was denied by the Circuit Court of Appeals for the Second Circuit in *Roche's Beach, Inc., v. Comm.,* 96 F.(2d) 776, 778-779, quoting I.T. 1945 above mentioned.

The Seventh Circuit held to the same effect in *Harrison v. Barker Annuity Fund,* 90 F.(2d) 286 (1937). The corporation there involved was required to disburse its income and corpus to charitable organizations and purposes specified from time to time by the donor. The Court held the corporation exempt under I.R.C. §101(6).

In *Willingham v. Home Oil Mill,* 181 F.(2d) 9, the Fifth Circuit followed the same rule. There a trust was created requiring the corpus and income to be paid to exempt institutions. (See District Court decision 68 F. Supp. 525 for the facts). The trust owned the stock

of a corporation which operated a business. The corporate articles required that the corporation be operated for charitable purposes. The Fifth Circuit held the corporation exempt under §101(6) even though it was two steps removed from what the Respondent calls a "functional" charity.

Estate of Louise V. Simpson, 2 T.C. 963, is to the same effect. Quoting from the *Roche's Beach* opinion and I.T. 1945, the Tax Court stated that it was not necessary to exemption under I.R.C. 1004(a)(2)(B), granting gift tax exemption in substantially the same language as I.R.C. 101(6), that a foundation itself engage in an exempt activity but it was sufficient that it furnished funds or property to other charitable organizations. No appeal was taken from this decision.

In *Eppa Hunton IV*, 1 T.C. 821, a trust was created with an insurance policy as the corpus, giving grantor's wife the right to designate any exempt organizations relieving poverty as recipients of the income of the trust. The court held that the trust was organized and operated exclusively for charitable purposes. The Commissioner acquiesed. 1943 C.B. 12.

That Congress understood this to be the settled meaning of §101(6) appears from a reading of the committee reports on the Revenue Act of 1950. Since Respondent seems to draw a different meaning from these committee reports (Br. 39-40, 55-56), we have set forth in the appendix to this brief extensive excerpts therefrom. Bearing on the "functional activities" theory of Respondent, attention is particularly called to the statements concerning "feeder organizations" in the House

and Senate Reports (App. *infra,* pp. 22). If Congress had felt that all feeder organizations were not or should not be exempt, it would have so expressed itself.

In making clear that the denial of exemption by the 1950 Act to organizations whose primary purpose is to conduct trade or business should apply only prospectively, the committee reports (App., *infra.* p. 21) discuss pending litigation as to the exemption for past years (*i.e., C. F. Mueller Co.,* and like cases). This discussion in the committee reports is stated to be with regard to "such feeder organizations" and the "area covered by this amendment," both phrases referring back to the language concerning primary purpose of operating a business and indicating the committee's belief that the litigation and consequent uncertainty as to the rule for past years was confined to cases where the primary purpose of the organization was to operate a business.

The cases cited by Respondent in support of a "functional requirement" (Br. 28) do not so hold. *U. S. v. Community Services,* 189 F.(2d) 421 (C.A. 4th), held that a primary purpose to engage in commercial enterprise was a non-charitable activity.

In *Bear Gulch Water Co. v. Commissioner,* 116 F. (2d) 975 (C.A. 9th), this Court held that a private business corporation organized for profit was not exempt, even after its stock was acquired by an exempt institution, where there was nothing in its own charter requiring its profits to go to exempt purposes. *Universal Oil Products Co. v. Campbell,* 181 F.(2d) 451 (C.A. 7th); *Gagne v. Hanover Water Works Co.,* 92 F.(2d) 659 (C.C.A. 1st); *Sun-Herald Corp. v. Duggan,* 160 F.

(2d) 475 (C.A. 2d), all involved the same situation as the *Bear Gulch* case.

Actually, if some "functional charitable activity" were necessary to exemption, Petitioner would still qualify. One of its functions was the furnishing of buildings, rent free, for the use of the Humanist Society of Washington, and the Humanist Society of San Francisco, both being "functional" exempt educational organizations. (R. 116). As the Tax Court said in *Estate of Louise V. Simpson,* 2 T.C. 963, 965, where the foundation rented its property to a school at cost:

> * * * An organization that acquires facilities and rents them at cost or furnishes them free of charge to a school is furthering education, in our view, as well as the agency that supervises the course of instruction.

B. Required Use of Funds for Exempt Organizations Is Only "Relationship" Necessary to Exemption

Recognizing that exemption has been accorded to organizations even though not conducting so-called "functional charitable activities," Respondent argues that in the absence of such activity there must be some "relationship" by which a "functional charitable activity" may be attributed to the trust. (Br. 25-31).

The word "relationship," like the phrase "functional charitable activity," is not to be found in the statute and is not defined, as far as we can find, in any decision or in Respondent's brief. From Respondent's argument, we gain the impression that the "relationship" he speaks of is a parent and subsidiary relationship of such a nature that the subsidiary can be treated as the *alter ego* of the parent.

Respondent admits that *C. F. Mueller Co. v. Comm.,* 190 F.(2d) 120 (C.A. 3d) and *Sico Co. v. U. S.,* 102 F. Supp. 197 (Ct. Cls.) are contrary to his argument. *Willingham v. Home Oil Mill,* 181 F.(2d) 9 (C.A. 5th) (Certiorari denied, 340 U.S. 852), is also contrary to his argument, even though Respondent seeks to distinguish it. While the Home Oil Mill corporation was wholly owned by a charitable trust, that trust was not itself engaged in so-called "functional charitable activities" but in turn supplied funds to a number of other exempt organizations. Furthermore, a previous District Court case, *Home Oil Mill v. Willingham,* 68 F. Supp. 525 (D. Ct. Ala.), cited with approval and followed by the Fifth Circuit, held that the exemption of Home Oil Mill was based on its own charter which specified that all property was held to produce income to be turned over to exempt institutions, using the language of §101(6) in describing those institutions just as was done in the case at bar, but leaving the particular institutions to be chosen from time to time by the directors of the corporation.

Also contrary to Respondent's argument are *Cummins-Collins Foundation,* 15 T.C. 613, where the board of directors (principally consisting of the grantors) had power to pay income or corpus from time to time to any charitable organization, and *William H. Donner,* 40 B.T.A. 80, where the beneficiaries were set forth in the language of I.R.C. §101(6) and the grantor had the power to designate the particular organizations as in the case at bar.

I.R.C. §101(6) speaks of "purposes" not "relationships." In no case that we have found has it been held

that a "relationship" as proposed by Respondent is necessary. On the contrary, the above cited decisions show that exemption exists as long as the income and corpus must be used to benefit exempt organizations.

I.R.C. §422(b) (added by §301(a) of the Revenue Act of 1950) uses the word "unrelated" in defining the Supplement U income of exempt organizations to be taxed after 1950. This section recognizes that use of income for exempt institutions is a "a relationship" since it expressly excludes it from the "relationships" which will be recognized in computing Supplement U income.

C. Destination Test of Exemption Has Been Generally Accepted

Respondent contests the accuracy of the statement made by this Court in *Squire v. Students Book Corp.*, 191 F.(2d) 1018, 1020, that most of the circuits have applied the "ultimate destination" test. (Br. 19). Nevertheless, we submit that this Court was correct in this statement. The decisions enunciating and following this test are as follows:

1. Supreme Court of the United States:

Trinidad v. Sagrada Orden, 263 U.S. 578, where the court stated:

> * * * Two matters apparent on the face of the clause go far towards settling its meaning. First, it recognizes that a corporation may be organized and operated exclusively for religious, charitable, scientific, or educational purposes, and yet have a net income. Next, it says nothing about the source of the income, but makes the destination the ultimate test of exemption.

2. Second Circuit:

Roche's Beach, Inc., v. Comm., 96 F.(2d) 776;

Debs Memorial Radio Fund v. Comm., 148 F. (2d) 948.

That the Second Circuit is consistently recognizing the destination test is shown by the statement in the recent case of *Consumer-Farmer Milk Coop. v. Comm.*, 186 F.(2d) 68, 70:

> It is true that a claim to exemption under section 101(8) is not barred merely because profit is derived from commercial operations provided the ultimate destination of the profit is charitable. * * *

3. Fifth Circuit:

Willingham v. Home Oil Mill, 181 F.(2d) 9 (Certiorari denied, 340 U. S. 852).

The recent case of *Mabee Petroleum Corp. v. U. S.*, decided April 17, 1953, recognizes this rule but holds the corporation taxable because it diverted funds to its founder.

4. Third Circuit:

C. F. Mueller Co. v. Comm., 190 F.(2d) 120.

5. Sixth Circuit:

Comm. v. Orton, 173 F.(2d) 483.

6. Court of Claims:

Sico Co. v. U. S., 102 F. Supp. 197.

The only Circuit Court case rejecting the destination test is *U. S. v. Community Services, Inc.*, 189 F.(2d) 421 (C.A. 4th).

Respondent contends that destination of income should not be the *sole* test of exemption. (Br. 20). Of course, it is not the *sole* test of exemption. If the organization is operated for the purpose of enhancing private

gain, even though none of the actual income or corpus of the organization will go to private parties, it is not exempt. *Better Business Bureau v. U. S.,* 326 U.S. 279; *Smyth v. California State Automobile Ass'n.,* 175 F. (2d)752 (C.A. 9th); *Universal Oil Products Co. v. Campbell,* 181 F.(2d) 451 (C.A. 7th). Moreover, if the organization was created as a private business corporation for private profit, it is not exempt simply because its stock is acquired by an exempt organization since the statute requires that it be both *organized* and operated for exempt purposes. *Bear Gulch Water Co. v. Comm.,* 116 F.(2d) 975 (C.A. 9th) (Certiorari denied, 314 U. S. 652); *Gagne v. Hanover Water Works Co.,* 92 F.(2d) 659 (C.A. 1st); *Universal Oil Products Co. v. Campbell, supra; Sun-Herald Corp. v. Duggan,* 73 F. (2d) 298 and 160 F.(2d) 475 (C.A. 2d). Some of the cases cited by Respondent on this point involved situations where the funds were actually used for private gain and thus would not qualify under the destination test itself. *Mabee Petroleum Corp. v. U. S.,* decided by C.A. 5th, April 17, 1953; *Stanford University Book Store v. Helvering,* 83 F.(2d) 710 (C. A. D. C.). See also *Consumer-Farmer Milk Coop. v. Comm.,* 186 F.(2d) 68 (C.A. 2d).

Where, however, the organization was created in such a manner as to exclude private gain and where it is also operated in that manner, the ultimate destination test, as this Court stated, has been applied by most of the circuits dealing with the problem.

D. Business Income Does Not Prevent Exemption

No contention is made by Respondent that Petitioner was organized and operated for the primary purpose of

engaging in a trade or business for profit. While Respondent does contend that Petitioner's primary purpose was to make money for contribution to exempt organizations (Br. 38), Respondent does not argue that such a purpose (which is consistent with ordinary trust investment) makes § 101(6) unavailable. Respondent does argue, however, that the receipt of any business income unrelated to a "functional charitable activity" defeats exemption. (Br. 38-46).

Insofar as this argument implies the necessity of a "functional charitable activity", we have previously discussed it. Insofar as it implies that an otherwise exempt organization loses that exemption whenever it happens to have business income, the argument is contrary to the decisions and to the intention of Congress.

We have discussed this subject at some length in discussing *U. S. v. Community Services, Inc.*, 189 F.(2d) 421 (C. A. 4th) at pp. 22-32 of our opening brief. In addition, we call the Court's attention to the fact that exemption was granted in the following cases where business income was received which had relationship to charitable activities only in that the income was required to be used to support those activities:

Roche's Beach, Inc. v. Comm., 96 F.(2d) 776 (C.A. 2d);

Willingham v. Home Oil Mill, 181 F.(2d) 9 (C.A. 5th) Certiorari denied, 340 U. S. 852;

C. F. Mueller Co. v. Comm., 190 F.(2d) 120 (C.A. 3d);

Sico Co. v. U. S., 102 F. Supp. 197 (Ct. Cls.).

Respondent appears to gather a different conclusion

from ours as to the meaning of the legislative history of the Revenue Act of 1950 on this question. He cites § 302(a) of the 1950 Act as intended to deny exemption for past years if any "unrelated" income is received, even though he admits that receipt of "unrelated" income for future years will not deprive the organization of exemption unless there was a primary purpose of operating a business enterprise. (Br. 39-40).

The committee reports on the 1950 Act (App. *infra*) make it clear that the purpose of that Act was to tighten the exemption for future years, not to liberalize it. In view of this over-all purpose, it would appear unlikely that Congress by the 1950 Act was granting exemption after that date where it did not exist before. The committee reports show that Congress believed organizations otherwise under § 101(6) to be exempt even though they received profits from a trade or business. Thus in Part III of the House Report, the committee states that the bill is designed to correct problems which have arisen in connection with "tax-exempt organizations", and that the provisions in Title III of the bill deal with the unrelated business income of certain "tax-exempt institutions". (App., *infra,* p. 21). See also quotations on pp. 30-31 of our opening brief. The Senate Bill is to the same effect. (App., *infra,* p. 25). It was only in cases where the operation of a business was the primary purpose of an organization that Congress indicated that there was litigation and uncertainty. (App. *infra,* p. 24).

Sec. 302(a) by its language is a protection of exemption for past years in certain instances. It is not a denial of exemption. It was designed to make certain, despite

pending litigation, that an organization having as its primary purpose the operation of a business would not be deprived of exemption if that business were related to the exempt activities of the organization.

As early as 1945, thirty nine percent of all the charitable and educational institutions which filed information returns listed business income as part of their total receipts. 35 Virginia L. Rev. 1001. If Congress in 1950 had intended retroactively to remove exemption from the very large number of charitable organizations involved, it would have done so by direct language, not by indirection.

Re-enactment of § 101(6) repeatedly without change does not support Respondent's argument as claimed (Br. 45), but the contrary, particularly in view of the fact that the judicial construction of this section, exempting organizations conducting business, was in 1942 specifically called to the attention of Congress and no change in the section was made. *C. F. Mueller Co. v. Comm.,* 190 F.(2d) 120(C.A. 3d); *Willingham v. Home Oil Mill,* 181 F.(2d) 9 (C.A. 5th); Hearings before the House Ways and Means Committee on the Revenue Act of 1942, Vol. 1, p. 89.

II.

Petitioner Is Entitled to Deduction of Its Income Under I.R.C. §162(a)

Respondent's admission (Br. 55-56) that deduction under § 162(a) prior to 1950 was not affected by the nature of the income (i.e., whether from business or investment or whether "related" or "unrelated"), and his further admission (Br. 56) that Congress interprets

§ 162(a) as meaning that a trust accumulating any income for charitable purposes was prior to 1950 not taxable thereon, narrows the inquiry under § 162(a) to whether petitioner has accumulated income for charitable purposes as contemplated by the two clauses of that section.

The denial that petitioner has accumulated any trust income (Resp. Br., p. 56) is not well taken. The findings show the net income of the trust, the distributions made, which were less than the income, and the resulting increase in net worth. R. 115, 116. The balance sheets set out in Joint Ex. 14N to the Stipulation of Facts, adopted by the findings, shows the corresponding increase in assets and reduction of liabilities. While a small part of the accumulation of income was represented by a reduction of liabilities, rather than by new investment assets (Joint Ex. 14N), nevertheless the reduction of liabilities gives that much greater equity in the trust assets held for charity and constitutes an accumulation under § 162(a). *Comm. v. Citizens and Southern National Bank,* 147 F.(2d) 977 (C.C.A. 5th). (See quotation on p. 54 of our opening brief.)

Petitioner, then, accumulated income for what Respondent admits (Br. 37-38) is a charitable purpose. Under the interpretation of § 162(a) by Congress (Pet. Opening Br., p. 59) this is sufficient to support the deduction. (See also Senate and Conference Reports on 1950 re accumulated income, App. *infra,* p. 22). Nevertheless, Respondent argues against the deduction by treating the second clause of § 162(a) as if it had no application to use of funds to support charitable activities of other organizations and by contending that there

is no permanent setting aside of the income under the first clause of § 162(a) because no specific organization was named in the trust instrument as a beneficiary and because trustees might lose the income in speculative investments.

As to the second clause of § 162(a), our opening brief (pp. 46-56) demonstrates that it covers use of income for charitable purposes through other organizations as well as directly by the trust. Many of the oldest and largest foundations in the country have power to and do use their income both directly and through other organizations. No matter which method is eventually employed as to a particular dollar of income, that dollar is still "used exclusively for * * * charitable * * * purposes" under the second clause of § 162(a).

Concerning the first clause of § 162(a), Respondent does not deny that the decisions hold that it is the provisions of the trust instrument, not the actions of the trustees, that constitutes the "permanent setting aside". (Br. 48-49). No case is cited by Respondent holding that to secure a deduction for income permanently set aside, the trust deed must name the specific organizations which will receive the fund. All of the cases relied on by Respondent in this argument involved provisions in the will or trust deed for payments to private parties leaving it uncertain whether the income was held for private or charitable purposes. See *Bank of America Nat. T & Sav. Ass'n. v. Comm.,* 126 F.(2d) 48; *Maloney v. Glover,* 171 F.(2d) 870, certiorari denied, 337 U. S. 917; *Boston Safe Deposit & T. Co. v. Comm.,* 66 F.(2d) 179 (C. A. 1st), certiorari denied, 290 U. S. 700; *Merchants Bank v. Comm.,* 320 U. S. 256, 263; *Langenbach's Estate v. Comm.,* 134 F.(2d) 590 (C.A.

6th); *Charles P. Moorman Home for Women v. U. S.,* 42 F.(2d) 257 (W.D. Ky.); *Huesman's Estate v. Comm.,* 198 F.(2d) 133 (C.A. 9th).

The contention that a named beneficiary is necessary is contrary to *Comm. v. Upjohn's Estate, supra.* Deduction under § 162(a) was there allowed even though the will specified no definite beneficiary, leaving it to the trustees to select them, and forbidding the trustees from making any distributions for ten years. Also opposed to Respondent's argument is *Boggs v. U. S.,* 27 F. Supp. 599 (Ct. Cls.). There the will left the estate for the benefit of such charities as the executor and decedent's sister should determine. No specific organization was named as a beneficiary. Deduction of the income was allowed under §219(b)(1) of the Revenue Act of 1926, the predecessor of I.R.C. §162(a). The Court of Claims said:

> As such income was received it was by the terms of the will permanently set aside and destined for charitable uses. Such income was clearly deductible.

To the same effect see *Wm. T. Bruckner, et al., Trustees,* 20 B.T.A. 419.

Examination of the governing instruments of the nation's largest foundations, as collected in Chambers, Charters of Philanthropies (1948), indicates that most of them specify no particular beneficiary, but leave the charitable beneficiaries to be selected in the future by designated parties, often including the donor. Certainly it has not generally been understood that § 162(a) was restricted in its application to foundations where some particular beneficiary is named.

No income was lost to charity by Petitioner's investments; to the contrary, the fund which is held for charity was substantially enhanced. Nevertheless, Respond-

ent argues that the power to make speculative investments deprives Petitioner of the deduction under § 162(a) because investments might in the future be unsuccessful.

Many, if not most, modern instruments creating charitable foundations give unlimited investment powers. See, for example, instruments set forth in Chambers, Charters of Philanthropies (1948). In a period of inflation the actual value of the fund may be threatened, rather than safeguarded, by too narrow an investment policy. There is risk in all investments, no matter what their nature.

Nothing in the language of § 162(a) forbids investment of the accumulated income held for charitable purposes, nor controls the type of investment. In almost every case where a deduction under § 162(a) is allowed, the accumulated income has been invested in some manner and stands some risk of loss due to bad judgment of the trustees. In no case that we know of has this risk been thought to make § 162(a) inapplicable.

The general understanding has been to the contrary. "Provided the eventual use of the money is described with clear certainty, it makes no difference that it is lost in unsuccessful investments or that the trustee may dissipate it." B. C. Eaton in 35 Virginia L. Rev. p. 850, discussing deduction under § 162(a).

Petitioner's investment policy, as pointed out in our opening brief (p. 25), has been in traditional types of charitable foundation assets. There is no basis to the contention that the earnings of Petitioner were not permanently set aside for charitable purposes simply because the trust instrument gave the trustees broad

powers to meet any investment situation that might arise. The practical necessity of broad powers is demonstrated by the present case where Petitioner's trustees were required to operate the Savoy Hotel for a period of time because of inability to find a suitable tenant.

III.

Returns on Form 990 Commenced Statute of Limitations

Sec. 302(b) of the Revenue Act of 1950 is cited by Respondent as prescribing that the returns of Petitioner on Form 990 do not start the statute of limitations. No such statement is to be found in that section, which simply made certain that the Commissioner would initiate no new proceedings in which he took the position that Form 990 was not sufficient to commence the statute. It left the pending cases, including that at bar, to be determined by the courts on the basis of existing law and said nothing one way or the other as to that question.

Respondent argues that Petitioner's returns on Form 990 were not income tax returns under the statute because Form 990 was a return to be filed only by exempt organizations and Petitioner has never established its right to exemption to the satisfaction of the Commissioner. However, I.R.C. § 101(6) does not make the exemption therein granted depend upon the determination of the Commissioner. If an organization complies with the requirements of § 101(6) it is exempt, irrespective of whether it has applied to the Commissioner for, or whether the Commissioner has granted exemption. *Saving Feature of Relief Dept. of B. & O. R. R.*, 32 B.T.A. 295 (Acq. XIV-1 C.B. 18). The regulations

themselves recognized that an organization claiming exemption should file Form 990 returns for periods prior to the filing of an exemption application. Regs. 111, § 29.101-2 (as added by T.D. 5381, June 26, 1944) stated[1]:

> * * * For proof and establishment of right to exemption from tax which must accompany Form 990 (Revised May 1944) in the case of an organization which has not established its right to such exemption prior to the filing of the annual return, see subsections (a) and (b) of this section.

Petitioner's trustees, therefore, acted in accordance with the law and regulations in filing income tax returns on Form 990 for the years here involved.

With regard to the contention that the returns on Form 990 did not supply the data on which the tax could be computed, we refer the court to Joint Exs. 2B, 3C and 4D. While all the figures are not identical with the later returns for the same years on Forms 1041 (Joint Exs. 6F, 7G and 8H), this is because the Form 990 returns contain items like "contributions received" that would not enter into Form 1041, and also because of correction of errors discovered prior to the filing of the 1041 returns.

CONCLUSION

The Tax Court should be reversed and directed to find that there are no deficiencies in income tax due from Petitioner.

Respectfully submitted,

F. A. LeSourd,
Attorney for Petitioner.

Dated: May 25, 1953.

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[1] Regs. 111, § 29.101-1, set out in the appendix to Respondent's brief (pp. 76-78), relates only to periods prior to January 1, 1943, none of which are here involved.

APPENDIX

Excerpts from Legislative History of Revenue Act of 1950

H. Rep. No. 2319, 81st Cong., 2d Sess. (1950—2 C.B. pp. 408-471):

III. Sources of Additional Revenue.

(E) *Educational, Charitable, and Similar Tax Exempt Organizations.*

Your committee's bill includes a series of amendments designed to correct certain problems which have arisen in connection with tax-exempt organizations. The provisions contained in title III of the bill deal with the unrelated business income of certain tax-exempt institutions, the so-called lease-back problem, the problem of accumulated investment income, and certain restrictions on the exemptions enjoyed by privately controlled trusts and foundations and on the deductions allowed to donors with respect to their gifts to such organizations.

(1) *Unrelated Business Income.*

Your committee's bill imposes the regular corporate income tax on certain tax-exempt organizations which are in the nature of corporations and the individual income tax on tax-exempt trusts with respect to so much of their income as arises from active business enterprises which are unrelated to the exempt purposes of the organizations.

* * *

The problem at which the tax on unrelated business income is directed here is primarily that of unfair competition. The tax-free status of these section 101 organizations enables them to use their profits tax-free to expand operations, while their

competitors can expand only with the profits remaining after taxes. * * *

Your committee's bill does not deny the exemption where the organizations are carrying on unrelated active business enterprises, or require that they dispose of such businesses, but merely imposes the same tax on income derived therefrom as is borne by their competitors.

* * *

(4) *Feeder Organizations.*

Section 301(b) of your committee's bill provides that no organization operated primarily for the purpose of carrying on a trade or business (other than the rental of real estate) for profit shall be exempted under section 101 merely on the grounds that all of its profits are payable to one or more organizations exempt from tax under this section.

* * *

(G) *Charitable Deductions by Trusts.*

Your committee has found that virtually the same problems exist with respect to the charitable, etc., income tax deduction taken by trusts under section 162(a) of the code as exist with respect to the charitable, etc., organizations which are exempt from income tax under section 101(6) of the code. Section 162(a) permits a trust which is taxable under Supplement E of the code to deduct any amount of its otherwise taxable income which, pursuant to the terms of the will or deed creating the trust, is "paid or permanently set aside" for charitable, etc., purposes. Thus, a trust which either distributes or accumulates its income for charitable purposes is, for all practical purposes, exempt from income taxes.

* * *

In order to correct this situation, your committee's bill provides limitations on the present section 162(a) deduction which are similar to the limitations the bill provides with respect to the section 101(6) income tax exemption. The section 162(a) deduction is made inapplicable to trade or business income, which is to be computed on the same basis as the unrelated business net income of exempt organizations.

Detailed Discussion of the Technical Provisions of the Bill:

TITLE III. *Treatment of Income of, and Gifts and Bequests to, Certain Tax-Exempt Organizations.*

Part I.—Taxation of Business and Other Income of Certain Tax-Exempt Organizations.

Subsection (a) of section 301 of the bill adds to the Internal Revenue Code certain provisions imposing a tax on the unrelated business net income of educational, charitable, etc., organizations and on the accumulated investment income of certain exempt organizations. * * *

Section 421. *Imposition of Tax.*

Subsection (a) of section 421 imposes a tax upon the Supplement U net income (as defined in subsection (c)) of certain organizations now exempt from Federal income tax by reason of sections 101(1), (6), (7), and 14) of the Internal Revenue Code. This tax is effective for taxable years beginning after December 31, 1950.

* * *

Section 301(*b*). *Feeder Organizations.*

Subsection (b) of section 301 of the bill adds a paragraph at the end of section 101 of the code to

provide that an organization operated for the primary purpose of carrying on a trade or business for profit is not to be exempt under any paragraph of section 101 of the code on the ground that all of its profits are payable to one or more organizations exempt from taxation under that section. It is also provided that for the purposes of this paragraph the term "trade or business" does not include the rental by an organization of its real property (including personal property leased therewith).

The determination of the tax treatment of such feeder organizations for taxable years beginning prior to January 1, 1951, is to be made as if this subsection of the bill had not been enacted and without inference drawn from the fact that the amendment made by this subsection of the bill is not expressly made applicable to such taxable years. In the area covered by this amendment there has been litigation as to the application of such a rule under existing law (cf. *Roche's Beach, Inc., v. Commissioner* (C.C.A. 2, 1938), 96 F.(2d) 776; *Universal Oil Products Co. v. Campbell* (C.A. 7, 1950), 181 F.(2d) 451; *Willingham v. Home Oil Mill* (C.A. 5, 1950), 181 F.(2d) 9; *C. F. Mueller Co.,* 14 T.C. No. 111½ May 25, 1950). The amendment is intended to show clearly what, from its effective date, the rule is to be, without disturbing the determination in present litigation of the rule of existing law.

* * *

The paragraph applies to organizations operated for the primary purpose of carrying on a trade or business for profit, as for example, a feeder corporation whose business is the manufacture of

automobiles for the ultimate profit of an educational institution.

* * *

Section 302. *Effective Date of Part I.*

Section 302 of the bill provides that the amendments made by part I of title III of the bill (the Supplement U tax rules so far discussed) are to be applicable only with respect to taxable years beginning after December 31, 1950.

S. Rep. No. 2375, 81st Cong., 2d Sess. (1950—2 C.B. pp. 483-568):

VIII. Educational, Charitable, and Certain Other Tax-Exempt Organizations, Foundations, and Trusts.

(1) *Income from an Unrelated Trade or Business Other Than the Rental of Property.*

The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of section 101 organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes. * * *

In neither the House bill nor your committee's bill does this provision deny the exemption where the organizations are carrying on unrelated active business enterprises, nor require that they dispose of such businesses. Both provisions merely impose the same tax on income derived from an unrelated trade or business as is borne by their competitors. In fact it is not intended that the tax imposed on unrelated business income will have any effect on the tax-exempt status of any organization. An organization which is exempt prior to the enactment

of this bill, if continuing the same activities, would still be exempt after this bill becomes law. In a similar manner any reasons for denying exemption prior to enactment of this bill would continue to justify denial of exemption after the bill's passage. * * *

(B) *Publicizing Instead of Taxing Accumulated Investment Income.*

The House bill would subject to tax, with specified exceptions, that part of the investment income of certain section 101(6) organizations which is not paid out on or before the 15th day of the third month following the close of the taxable year in which the income is received. * * * The House bill would also, with certain exceptions, deny trusts the charitable, etc., deduction under section 162(a) if they do not distribute the income reserved for charitable, etc., purposes within 2½ months after the end of their taxable years. * * *

Your committee has rejected this accumulations tax and substituted for it the requirement that information disclosing the extent of accumulations must be made available to the public. * * * To mention some problems under the House provision:

(1) A foundation could not use any of its income to endow another organization unless the latter was of a type not subject to the accumulations tax.

(2) A foundation could not set aside funds which, if subsequently matched by another organization, would be spent for some specific purpose.

(3) Foundations may find that as the result of a crisis, such as a war, they are unable to spend their funds for a period of time for the purposes for which they were organized.

(4) Funds irrevocably set aside in a 5-year trust

fund as provided by the House bill may not be needed at the end of the 5-year period for the specific project for which they were set aside, and

(5) One year's earnings, the accumulations permitted by the House bill, may not be sufficient to even out variations in the earnings or needs for funds of a foundation.

It is believed that publishing information about the accumulations of these foundations and trusts will serve two purposes. First, full public information will encourage distributions. Second, it will reveal the extent of the accumulations problem.

* * *

(C) *"Feder" Organizations.*

The House bill provides that no organization operated primarily for the purpose of carrying on a trade or business (other than the rental of real estate) for profit shall be exempt under section 101 merely on the grounds that all of its profits are payable to one or more organizations exempt from tax under this section. Your committee has accepted this provision of the House bill.

H. Conf. Rep. No. 3124, 81st Cong. 2d Sess. (1950--2 C.B. pp. 590, 591).

* * *

Amendment No. 151: This amendment strikes out provisions of the House bill which would have added sections 424 and 425 to the Internal Revenue Code, which would have subjected to the Supplement U tax certain accumulated investment income of trusts and certain other organizations exempt under section 101(6) of the Code. The House recedes.

* * *

Amendment No. 159: This amendment eliminates those provisions of the House bill which would have denied a deduction under section 162(a) of the Internal Revenue Code with respect to income which was accumulated, and also the privilege of election which would have been granted trustees to deduct under section 162(a) for certain distributions made after the close of the taxable year. This amendment retains, with modifications, the limitations proposed in the House bill on the unlimited charitable deduction allowed trusts under section 162(a) of the Code. These provisions appeared in section 162(g) (2) and (4), as added to the Code by section 321 of the bill as passed by the House. These limitations, which now appear as section 162(g) (1) and (2), result in the denial of a deduction under section 162(a) of the Code for amounts attributable to income derived from business activities of the trust and for amounts in excess of 15 per cent of the net income if the trust has engaged in certain prohibited transactions, directly or indirectly with the creator of, or a substantial donor to, such trust.

* * *

The House recedes with clerical amendments and an amendement which adds paragraph (4) to section 162(g), which paragraph provides that the amount which would otherwise be allowed under section 162(a) as a deduction for amounts permanently set aside for charitable and related purposes during the taxable year or any prior taxable year and not actually paid out at the end of the taxable year shall be limited to such amounts as actually paid out as are not in excess of 15 per cent of the net income of the trust, computed without the benefit of section 162(a), where the accumula-

tions are (1) unreasonable either in size or duration, or (2) used to a substantial degree for other than charitable or related purposes, or (3) invested in such a manner as to jeopardize the interests of the religious, charitable, scientific, etc., beneficiaries. The deductions are to be so limited as provided in this paragraph in the year in which the accumulation becomes unreasonable or is misused and will continue to be so limited until such situation is corrected.